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The Brattle Group

Power Procurement for Second-Stage Retail Access

**Prepared for
Post 2006 Symposium
Chicago, IL**

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April 29, 2004

Agenda:

Key Ingredients for Successful Procurement

1. Thorough Commission understanding and oversight of market conditions and utility procurement
2. Strong commitment to fostering and relying upon wholesale market competition
3. Reduced ambivalence over customer switching and obligation to serve, which makes the size and horizon of the procurement problem unduly uncertain
4. Enhanced regulatory “tool kit” for combining risk management with least cost planning, diversification, etc.
5. Increased *a priori* guidance for utility procurement plans and processes
6. Flexibility and readiness to adjust over time without prejudice

1. Market and Procurement Oversight

Commission must be keenly aware of current and prospective market conditions, and utility supply portfolio composition, for at least 3-5 years forward (capacity development horizon)





- Know what to expect and allow as just and reasonable procurement results, *e.g.*, size of risk premiums, differences in cost between procurement installments or horizons
- How/whether to include social goals in utility guidelines

Market and Procurement Oversight *cont'd*

- Adjust utility supply goals and procurement approaches according to market conditions
 - 💾 Volatility → hedging, rolling procurement contracts
 - 💾 Reliability/boom-bust cyclicalality → longer horizon, solicit new construction
 - 💾 Market power → diversified procurement, pricing standards, transmission expansion, price responsive demand





Wholesale power procurement is now typically the largest line item of cost of service

2. Fostering Wholesale Power Competition

- A workably competitive wholesale market is a prerequisite for economical retail supply
- Wholesale competition fostered by
 -  Requiring utilities to use transparent, open procurement processes to solicit supply from third parties
 -  Encouraging price responsive demand, transmission expansion
 -  Intervening in FERC and RTO market monitoring rulemaking
 -  Level playing field between third-party and utility-affiliated gencos

Fostering Wholesale Power Competition *cont'd*

Some degree of affiliate supply essential given Illinois' current wholesale market structure, but safeguards are needed

- Good market-based benchmarks as regional market becomes more competitive under RTOs
- In near term, may need to consider measures such as:
 -  Taking prices from auctions or RFPs in which affiliate bidding is limited
 -  Tying prices to unaffiliated transactions in Illinois, or to a regional competitive proxy (Cinergy daily into)
 -  Affiliated gencos selling “strips” of capacity to 3rd parties for a specified period – creates more sellers
 -  Cost-based pricing as fall-back

Other States'

Treatment of Affiliate Procurement


All states with major affiliated suppliers are exploring some form of control or oversight.

CA	Affiliate purchases (and self-build) permitted under new procurement framework – reviewed on a case-by-case basis
TX	Affiliated gencos required to sell one- and two-year strips of capacity
MD	Affiliate purchases permitted but procurement via mandatory auction with extensive Commission oversight
NJ	Mandatory state-wide auction permits affiliate purchases. However, utility-affiliated gencos have sold significant portions of their capacity via bilateral contracts to other bidders rather than bid into the auctions.





3. Resolving Customer-Switching Dilemmas

First-phase transition to retail access was partly self-defeating due to POLR protections given to non-switching and prodigal customers

- Customer switching heightens uncertainty over size of utility demand requirements and relevant procurement horizon; adds risk management elements to the problem.

 Large customers in particular will switch opportunistically if given the opportunity

Resolving Customer-Switching Dilemmas *cont'd*

- Must decide how/whether second transition will be different:
 -  Some degree of real-time exposure, to encourage risk management value-added retail services?
 -  POLR to be phased out over time, or perpetual?
Equally so for all customer classes?
 -  Charge customers for switching option value?
 -  Prodigious customers offered same service as non-switchers?

Option pricing and hedging techniques can help inform many of these questions

4. Enhanced Regulatory Tool Kit

The post-restructuring world injects many complications into utility procurement that were not so prevalent in the past. Volatility is the biggest culprit:

- Creates a strong need for risk management, but guidelines for how much risk to control and how to review risk management performance not in place
- Also creates pressure for diversification, but analogy to financial market is inapt, and again there is little/no guidance for when/how diversification useful

Enhanced Regulatory Tool Kit *cont'd*

- Volatility plus the proliferation of traded, wholesale market supply contracts create increased hindsight risk, because some *ex post* strategy almost always cheaper than resources actually used.

Risk Management is not Least Cost Planning:



- Risk Management does not reduce expected costs, just narrows the range of possible costs
- Confusion between RM and LCP adds risks to utilities and their suppliers

5. “Upstream” Regulatory Reviewers

For several reasons, there is an increased need for regulatory review processes to move upstream in the timeline of utility procurement decision-making:

- Goals and approaches for procurement may shift with market conditions; utilities will require Commission agreement on “turning points” when changes are needed
- No existing guidelines for how much risk utilities should seek to reduce from customer bills, nor how utilities should trade such efforts against allowing ARES to provide risk management

“Upstream” Regulatory Reviewers *cont’d*

- Credit risk of utilities (another new problem) increases if cost-recovery approval is delayed and conditional on traditional prudence scrutiny
- Price terms for some procurement alternatives may be very short-lived:
 -  Risk management contracts may go stale in hours
 -  Auction procurement results may need Commission acceptance as competitive, just and reasonable, within a couple of days of bidding

Regulators cannot be expected to give *carte blanche* to pre-approved plans, but they can/should define acceptable procurement frameworks, then review utility performance for adherence to the guidelines.

6. Flexibility and Adjustments Over Time

To date, no system is “best and final”; all are evolving. Illinois must expect to adjust over time, without prejudice against results of prior procurement regime.

- More differentiation among customer needs
- More blending of various contract horizons
- More Commission pre-approval and involvement

“Deregulation” is a misnomer – at least in transition, information and review requirements increase

But, Illinois conditions are more auspicious than most, and there is time to settle on new procedures before they constrain results.